Adoption of International Financial Reporting Standards

Prudential Implications for Life Insurers and Friendly Societies

Issues Paper

23 November 2004
Introduction

Recent developments in International Financial Reporting Standards (IFRS) have raised a number of important issues for life insurers and friendly societies. The LIASB (the Board) has been monitoring these developments in order to determine their likely effects on life insurers and friendly societies and to assess what changes will need to be made to the Actuarial Standards.

This paper is intended to inform readers of the Board’s thinking on the IFRS developments.

The Board would prefer to keep the Actuarial Standards aligned, as closely as possible, with the requirements of general reporting standards. However, the Board’s fundamental priority is to fulfil its obligations under the Life Insurance Act 1995. This paper will concentrate on those areas where, in the light of its legislative obligations, the Board currently believes that it may be difficult to align the requirements of the Actuarial Standards and the general reporting standards.

It needs to be recognised that the practical interpretation of IFRS within the industry is not yet settled and that international developments may result in further changes to accounting standards within only a short period of their initial implementation. Finalisation of the prudential response may therefore take some time. However, despite this uncertainty, IFRS is being implemented, and the Board needs to proceed in developing its response to the revised accounting standards as most recently published.

The Board intends to work closely with the Australian Prudential Regulation Authority (APRA) during this process. APRA recently undertook a survey of the financial impact of IFRS on life insurers and friendly societies. The findings of that survey will be taken into consideration during the process of determining the Board’s response to IFRS.

APRA has outlined the approach that it will be taking during the implementation of IFRS in a recently issued Overview Paper. While APRA will be revising its prudential standards and statistical requirements for all prudentially regulated institutions, it intends to take a measured approach to evaluating the financial and prudential implications for regulated industries and will not make any IFRS-related changes to the existing prudential framework until it has completed relevant consultations, and not before 1 July 2005 at the earliest.

This approach may, for a time, widen the divergence between accounting and regulatory reporting. In the interim, life insurers and friendly societies will need to continue to comply with, and report in terms of, current prudential standards.

In addition, the Board has recently been considering other changes to the Actuarial Standards for the purpose of clarifying appropriate interpretations. This paper will also discuss these additional issues.
Recent Developments in IFRS

International Financial Reporting Standards are issued by the International Accounting Standards Board (IASB). They set out the recognition, measurement, presentation and disclosure requirements of general purpose financial reporting statements for profit-oriented entities.

In July 2002, the Financial Reporting Council directed the Australian Accounting Standards Board (AASB) to adopt the IFRS issued by the IASB for reporting periods beginning on or after 1 January 2005.

In October 2003 the Board made a submission to the AASB. The submission outlined the Board’s views on the methods that the AASB intended to use in order to bring AASB 1038 into line with the developing IFRS. The Board’s submission covered several major areas:

- recognition of the excess of net market value over net assets of a subsidiary;
- use of fair value to measure the assets backing insurance liabilities;
- fair value of insurance contracts and the implications raised for deferral and matching, as well as surrender floors;
- discounting of deferred tax liabilities;
- use of a risk-free discount rate where the value of insurance liabilities is independent of the value of the assets backing them.

Since the Board made its submission to the AASB, the IASB has issued the majority of its suite of IFRS. The AASB has also now released its own Australian equivalents for the purpose of the 1 January 2005 deadline.
Background

The current general purpose financial reporting of life insurers (and for friendly societies as well, were it not for an exemption granted under ASIC Class Order 99/1225) is largely governed by AASB 1038 Life Insurance which is effectively a self contained industry specific standard. Under the current AASB 1038:

- All assets of a life insurer are measured at net market value and all liabilities are measured at net present value using discount rates based on the expected investment yield on the assets backing the liabilities.
- Consistent with the measurement of assets at market value, an amount representing the excess of market value over net assets (EMVONA) of a subsidiary is included as an asset in the consolidated balance sheet of a life insurer.
- Premiums and claims must be separated on a product basis into the components representing revenue, expense and change in liability unless the separation is not practicable.
- Revenues include all income and gains on investments controlled by a life insurer.
- All participating benefits (vested and unvested) must be recognised as expenses.
- The adequacy of recognised insurance liabilities is tested, and allowance is made for reinsurance recoveries on the best estimate assumptions for calculating net policy liabilities (thus implicitly testing reinsurance assets for impairment).
- Tax assets and liabilities must be discounted to present values.

Under IFRS the accounting treatment of a life insurer’s business will no longer be determined solely according to a single accounting standard. This includes the treatment of policy liabilities where the treatment will depend on the type of contract issued. Different contracts issued by one insurer will be treated differently for accounting purposes. The principal policy liability requirements are contained in the following standards, all of which may be relevant depending upon the particular nature of an insurer’s operations:

- AASB 4/IFRS 4 Insurance Contracts;
- AASB 1038 Life Insurance Contracts (as amended);
- AASB 139/IAS 39 Financial Instruments: Recognition and Measurement;
- AASB 118/IAS 18 Revenue

AASB 4 defines insurance contracts and draws a distinction between insurance risk and financial risk. An insurance contract is defined as a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified future event (the insured event) adversely affects the policyholder. Insurance risk is risk other than financial risk. Financial risk is defined as the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided, in the case of a non-financial variable, that the variable is not specific to a party to the contract. Insurance risk is significant if and only if an insured event could cause an insurer to pay significant benefits in any scenario, excluding scenarios that lack commercial substance. AASB 4 (and hence AASB 1038) applies to insurance and reinsurance contracts issued and reinsurance contracts held.
AASB 4 requires life insurers to follow the requirements in AASB 1038 for life insurance contracts (including contracts issued by friendly societies). The existing Margin on Services method for the measurement of life insurance contract liabilities will therefore continue to be allowed.

A contract that does not meet the definition of an insurance contract (i.e. that transfers insignificant amounts of insurance risk) is an investment contract. Investment contracts are treated under AASB 139 *Financial Instruments: Recognition and Measurement* to the extent that they give rise to financial assets or financial liabilities. To the extent that an investment contract includes a management services component it is treated under AASB 118 *Revenue*.

The types of contracts that are expected to satisfy the definition of an insurance contract include:

- term insurance (including riders);
- traditional whole of life and endowment contracts;
- disability insurance;
- life annuities; and
- non-financial reinsurance

Participating contracts (both traditional and investment account) are subject to grandfathering under national GAAP and thus will continue to be subject to AASB1038 and Margin on Services, regardless of the level of insurance risk entailed.

Typical investment contracts, no longer valued using Margin on Services, will include:

- non-participating investment account policies;
- all investment linked contracts (excluding riders);
- allocated annuities;
- term annuities; and
- financial reinsurance

Life insurers will also need to consider the requirements in other standards such as AASB 3 *Business Combinations*, AASB 136 *Impairment of Assets* and AASB 112 *Income Tax*.

The requirements of the revised AASB 1038 attempt to adopt a fair value measurement approach for both the assets backing insurance contracts and the liabilities for investment contracts, to the extent practicable within the constraints of IFRS. This approach is intended to ensure (as far as possible) consistency in measurement between assets and liabilities. The adoption of the fair value measurement options in other AASB standards such as AASB 116 *Property Plant and Equipment*, AASB 140 *Investment Property*, AASB 131 *Interests in Joint Ventures*, AASB 128 *Investment in Associates* and in AASB 139 *Financial Instruments: Recognition and Measurement* is therefore mandated for assets backing insurance contract and investment contract liabilities.

Under AASB 139 “fair value” is closely aligned to market value where there is an actively traded market. Fair value is defined ‘for an asset held or liability to be issued’ as ‘usually the current bid price’.
AASB 1038 does not define ‘assets backing life insurance liabilities or ‘life investment contract liabilities’. Instead, it places responsibility on life insurers themselves ‘to disclose the process used to determine which assets back life insurance liabilities or life investment contracts’.

In considering insurance contracts, AASB 4 also states that:

- The deposit component of insurance may be “unbundled” if it can be separately measured. Contracts which are unbundled would need to be split and the investment and insurance components valued separately.
- Insurers must test for the adequacy of recognised liabilities and apply a separate impairment test to reinsurance assets.
- Insurance liabilities must not be offset against related reinsurance assets.
- Insurers must provide additional disclosures that explain the amounts recognised in the accounts in respect of insurance contracts so that users can understand the amount, timing and uncertainty of future life insurance cash flows.

Other requirements under the suite of international standards also mean that:

- Life insurers are no longer able to recognise all of the EMVONA as an asset in the consolidated balance sheet.
- Life insurers are no longer able to discount their deferred tax assets and liabilities.
- Life insurers must recognise on their balance sheets any surplus or deficit in defined benefit superannuation funds for which they are the employer sponsor.

Independent of changes arising from IFRS, the requirements of AASB 1038 in relation to discount rates have also been changed. Insurance contract liabilities must now be determined using risk-free discount rates i.e. current observable, market-based, objective rates that directly relate to the nature, structure and term of the cash flows. The earning rates on actual assets held may be used only where the benefits under the contract are linked to the performance of those assets.

In summary then, in the context of insurance contracts, there have been changes to AASB 1038, but in general the existing policy liability calculation methods and processes will continue with the changes outlined above. For investment contracts however, the changes in calculation of liabilities may be significant.
Financial Reporting Issues Arising from IFRS

The new accounting standards have significant effects in a number of areas that are relevant to life insurers and friendly societies.

Measurement of Assets at Fair Value

Most types of assets that back Policy Liabilities will be required to be measured at fair value which will usually be the current bid price of the asset. Current prudential standards are based on the measurement of assets at net market value, being usually the mid (or last sale) price less an allowance for realisation costs. Preliminary analysis of the results of the recent APRA survey on IFRS impacts indicates that for some asset classes, most notably direct property, realisation costs exceed the difference between bid and mid (or last sale) prices.

The Board considers that it is appropriate to make an explicit allowance for realisation costs, as a deduction from the reported fair value of assets (i.e. as a deduction from the current bid price), particularly for solvency, capital adequacy and management capital measurement purposes and intends to liaise with APRA to consider how this might best be achieved.

Measurement of Assets Not Backing Policy Liabilities

Under the revised accounting standards, assets that do not back Policy Liabilities (primarily the assets in the General Fund – i.e. Shareholders’ Fund or Management Fund – but possibly some assets in the Statutory Funds as well) will not necessarily be measured at fair value. Insurers will be able to use any available valuation option.

This will have several ramifications. An insurer’s reported profit may no longer be “realistic”. Moreover, as the current prudential standards are based on measurement of assets at net market value, the availability of alternative valuation methods may impact the effectiveness of the current prudential regime.

The Board intends to liaise with APRA to discuss possible changes to PR35 requiring the use of fair value in the valuation of all of the assets of a statutory fund (including those backing shareholders’ interests) and possibly of the General Fund as well.

Measurement of Assets Not Measured at Fair Value Through Profit and Loss

The new accounting standards require that owner occupied property, plant and equipment be measured at fair value, with any increases in fair value being credited directly to equity. The Board considers that an insurer’s regulatory reported profit may need to incorporate changes in the fair value of assets that are held to back discretionary or investment linked business to ensure that there is no actual or perceived impediment to maintaining equity between policyholder groups and between policyholders and shareholders.
Treatment of Deferred Acquisition Costs

Under the revised accounting standards, the treatment of acquisition costs of investment contracts (i.e. contracts issued by a life insurer that do not meet the definition of an insurance contract) will change. To the extent that an investment contract contains a management services component it will be subject to AASB 118 Revenue. Under that standard a deferred acquisition cost asset may be recognised on the balance sheet to the extent that relevant acquisition expenses that are allowed to be deferred can be recovered from future management services revenues. Amortisation of this asset in accordance with the expected future pattern of revenues would be largely consistent with existing life insurance practice although other patterns of amortisation (e.g. in proportion to the overall pattern of expenses as they are incurred) may also be possible under AASB 118.

It is important to note that the level of acquisition costs able to be deferred in respect of investment contracts (which effectively excludes overheads) will be less than that implied in the current liability calculations for life insurers. For insurance contracts there is no change to the current treatment of acquisition costs. Hence, in the absence of any other change, acquisition costs allocated to investment contracts will be treated differently from acquisition costs allocated to insurance contracts.

Where AASB 118 is applied to the amortisation of acquisition costs for life investment contracts the impacts will be:

- Recognition of a DAC asset on the balance sheet (rather than as an implicit offset within the liability), thus increasing the entire balance sheet, both assets and liabilities;
- A lower level of DAC (and hence a higher net liability) than is implicit in existing liability calculations; and
- Amortisation of that DAC asset in a manner which may differ from that implicit in existing liability calculations.

This will have the greatest effect for life insurers that write investment linked and fixed term annuity business.

Under the current prudential requirements, all or part of the "implicit" DAC asset is effectively eliminated by the application of Minimum Termination Value and Current Termination Value minima. The Board does not, therefore, foresee any major prudential issues arising from a reduction in the level of DAC and changes in its pattern of amortisation.

The Board is, however, discussing with APRA whether PR35 should allow for the DAC to be presented as an asset or continue to be held as an offset from the liabilities. In regard to this issue, the Board’s aim is to achieve a prudential outcome that is broadly equivalent to the status quo. If the DAC is to be treated as an asset then an appropriate treatment under the solvency and capital adequacy standards will need to be determined in order to achieve this.

The Board will also need to consider whether it is appropriate to treat acquisition costs differently for insurance contracts and investment contracts. If a consistent treatment is preferred then changes to the application of Margin on Services will be required in due course.
The Board is also aware of a potential interpretation of AASB 118 that would require the deferral and amortisation of some establishment fees, and other fees intended to recover acquisition costs, as a deferred revenue liability. This is potentially a significant change from current practice where such fees are recognised as revenue at inception. If such a deferred revenue liability is included in the total accounting liability, it could produce an accounting liability that is excessively conservative relative to that obtained from the prudential solvency and capital adequacy assessment.

The Board is waiting on further clarification of how AASB 118 is to be interpreted before deciding what response, if any, is required.

**Application of Surrender Value Minimum to Fair Value of Financial Instrument Liability**

The financial instrument component of an investment contract will be measured at fair value under AASB 139. However, the fair value measure is subject to a minimum of “the amount payable on demand, discounted from the first date that the amount could be required to be paid”.

For contracts with surrender penalties that exceed ongoing fee margins (i.e. “lapse-supported contracts”) the minimum as defined in AASB 139 could be higher than the current surrender value. This may result in a policy liability that is higher than the termination value minima applicable under the current prudential solvency and capital adequacy requirements.

The Board is waiting on further clarification of how the relevant accounting requirements are to be interpreted, before deciding what response, if any, is required.

**Treatment of Bundled Contracts**

The new standard AASB 4 gives life insurers flexibility in their approach to bundled contracts. If the life insurer chooses to unbundle contracts, then the investment component will be measured under AASB 139/118. However, if the contract remains bundled, then the entire contract must be measured under AASB 1038. This could result in different reporting outcomes for identical insurance contracts, depending upon the insurer’s approach to unbundling.

The Board intends to liaise with APRA to discuss whether PR35 should allow the same degree of flexibility as AASB 4 or whether it should mandate unbundling.

The Board does not expect the unbundling requirements to cause major difficulties for Australian life insurers as, for business where the deposit component can be separately measured, the insurance riders are, in most cases, already unbundled. This is due to the requirement that investment linked business be held in a separate statutory fund. In addition, the unbundling requirements largely align with insurers’ existing practices in relation to premium and claim splitting.


**Embedded Derivatives**

AASB 139 includes specific disclosure requirements for embedded derivatives within insurance contracts and specifies that they be measured at fair value except where the embedded derivative is itself a life insurance contract or a cash surrender option. This exception is expected to exempt most common options that exist under Australian insurance contracts, and where it does not, the Actuarial Standards already require allowance to be made for options and asymmetries in the cash flows. It is not expected, therefore, that embedded derivatives will be a significant issue for Australian life insurers.

**Rights under Reinsurance Contracts**

The revised standard AASB 1038 imposes a recoverability test on an insurer’s reinsurance assets. The Board is considering the need to refine the basis under which reinsurance is allowed for in the Standards.

**Use of “Risk Free” Discount Rate**

The revised version of AASB 1038 requires the use of risk free discount rates to measure policy liabilities for business where the benefits are not dependent on the performance of the assets backing the liabilities. Risk free rates are defined as current observable, objective rates that directly relate to the nature, structure and term of the cash flows. The Board considers that it would be a sensible move to align the discounting methodologies within Actuarial Standard AS1.03 with those in the revised AASB 1038.

The Board intends to liaise with the Institute of Actuaries of Australia (IAAust) to ensure that appropriate actuarial guidance is available for the determination of discount rates. The Board understands that the IAAust is currently working to produce guidance on the appropriate interpretation of the term risk free rate. Once this is established the Board will need to consider the implications for the discount rate to be used in the calculation of the solvency and capital adequacy liabilities – i.e. whether the same risk free rate can be used with or without further adjustment.

The treatment of participating business, where the best estimate liability relates to guaranteed benefits that are not dependent on the performance of the assets backing them, will require particular consideration.

The change in the method of selecting discount rates may represent a significant departure from existing practice for business where benefits are not dependent on the performance of the assets backing them. The result is expected to be an overall increase in best estimate liabilities. In the case of existing business, the Board notes that a precise recalculation of total policy liabilities from inception (as is otherwise required on initial adoption of IFRS) may be difficult and/or not feasible. If the Board were, in due course, to adopt risk free rates for the calculation of policy liabilities under the Life Insurance Act, it may prefer to consider such a change as being equivalent to an assumption change (with the change in best estimate liability offset by a corresponding reduction in profit margins, subject to the impact of the loss recognition test). It would be desirable if a similar approach proves acceptable in implementing IFRS for general purpose financial reporting.
Treatment of EMVONA and Other Impacts in Consolidated Accounts

The new accounting standards affect the basis for the consolidation of subsidiaries. In the parent entity accounts, investments in subsidiaries held in statutory funds will need to be measured at fair value if backing policy liabilities. However, in consolidated accounts, investments in subsidiaries held in statutory funds are effectively measured at net assets. It will thus not be permissible to recognise the excess of net market value over net assets in the consolidated accounts.

Differences between the parent entity and consolidated accounts may also arise in respect of investments in associates and joint ventures that are not backing investment linked or participating contract liabilities.

The Board considers that prudential standards should continue to be based on unconsolidated accounts. The impact of these items on the consolidated accounts does not therefore give rise to prudential concern.

The Board intends to liaise with APRA to discuss the appropriate measurement of subsidiaries which are not backing policy liabilities and the appropriate treatment of EMVONA in determining the solvency and capital adequacy reserves for inadmissible assets, having regard to its treatment in other APRA regulated industries.

Discounting Deferred Tax Assets and Liabilities

IAS12, the standard covering the treatment of income tax, does not allow the discounting of deferred income tax liabilities. The Board notes that this could generate profit volatility where there are inconsistencies between the treatment of deferred tax for accounting purposes and its treatment in the policy liabilities and that the inability of life insurers to discount their deferred tax assets and liabilities could result in a reduction in retained earnings on the implementation of IFRS (because deferred tax liabilities will need to be increased). The Board is also concerned that policyholder entitlements may be adversely affected by changes to the allowance for tax within unit prices.

Other inconsistencies may also arise between the published unit prices and the net assets as reported in the published accounts.

In regard to this issue, the Board’s aim is to achieve a prudential outcome equivalent to the status quo. The Board is discussing with APRA how these inconsistencies might be dealt with under PR35 and what changes might be required to the solvency and capital adequacy standards as a result. However, the Board’s current intention is that published unit prices should continue to be used in determining solvency and capital adequacy requirements.

Recognition of Defined Benefit Fund Surpluses and Deficits

The Board is considering the issue of how to treat assets and liabilities arising from the recognition of defined benefit fund surpluses and deficits, and is liaising with APRA with the aim of achieving a consistent treatment across all APRA regulated industries.
Regulatory Issues Arising from IFRS

The Board, working with APRA and the IAAust, will ultimately need to alter some of its standards with respect to life insurance and friendly societies.

Interim Response

APRA has advised regulated institutions that it will not be making any IFRS-related changes to prudential and reporting standards before 1 July 2005 at the earliest. Until further notice from APRA, life insurers and friendly societies should continue to report in terms of current requirements. For this purpose, APRA will make appropriate determinations to preserve the use of Australian accounting standards existing as at 31 December 2004, until any changes to the prudential and reporting standards are finalised.

This means that the existing Actuarial Standards will continue to apply for the time being, and will continue to utilise accounting quantities determined in accordance with pre-IFRS accounting standards. The most immediate implication of this will be for Appointed Actuaries in certifying that solvency and capital adequacy requirements have been continually satisfied.

Life Insurance

There are a number of areas where, in the longer term, changes may be required in the Actuarial Standards. Examples that arise out of the previous discussion include:

- A new Valuation Standard (or a separate section in the existing Valuation Standard) will be required to address the valuation of investment contracts. It is expected that this will be consistent with the requirements of AASB 139 and AASB 118 but with the following potential constraints:
  - For consistency with the revised AASB 1038, the financial instrument component must be measured at fair value. Amortised cost will not be permitted.
  - To align with changes that may be made to PR35 in relation to the treatment of deferred acquisition costs and establishment fees, some modification of the liability valuation may be needed.
  - Inclusion of the appropriate asset recoverability and impairment requirements.

- Possible amendments to the existing Valuation Standard (AS 1.03 - which will now only apply to insurance contracts) to align with changes incorporated in the revised AASB 1038 in the following areas:
  - The discount rate used where the benefits do not depend on the performance of the assets.
  - The loss recognition (liability adequacy) test (to allow for any intangible assets that would have arisen from acquisition of a portfolio of insurance contracts).
  - Treatment of asymmetries (to align with the required treatment of embedded derivatives).
  - The impact of reinsurance on the net policy liabilities of the cedant (to support disclosure of the profit impact of effecting reinsurance).
  - Treatment of reinsurance in the context of best estimate assumptions (to align with the required impairment testing of reinsurance assets).
• Expense allocations (to identify incremental costs separately from other acquisition expenses in respect of investment contracts).

• Possible amendments to the Solvency Standard (AS 2.03), to address issues relating to:
  o The difference between “net market value” and “fair value”.
  o Changes to the discount rates used to calculate liabilities.
  o Any assets whose values may not be calculated at fair value under the accounting standards.
  o The treatment of deferred acquisition costs and establishment fees.
  o The inability to discount deferred tax liabilities and other inconsistencies between unit prices and reported net asset values.
  o The treatment of EMVONA under the inadmissibility rules.
  o The treatment of superannuation fund surpluses and deficits.
  o Any other changes that the Board has on its agenda, and which it would be appropriate to implement at the same time.

• Equivalent amendments to the Capital Adequacy Standard (AS 3.03).
• Equivalent amendments to the Management Capital Standard (AS 6.02).

**Friendly Societies**

Friendly societies are currently exempt from the requirements of AASB 1038 under ASIC Class Order 99/1225 which is applicable for financial years commencing on or before 31 December 2004. However, ASIC has advised that the class order will not be extended. In addition to the issues identified above, friendly societies will therefore need to adopt Margin on Services accounting for insurance contracts for general purpose reporting – i.e. the revised AASB 1038 will apply.

The Board understands that the IAAust is investigating a practical approach to Margin on Services that takes account of the simplified products and not-for-profit fund structure of friendly societies while complying with the requirements of the revised AASB 1038. The Board supports this initiative and, where appropriate to do so, will endeavour to assist its implementation.
Other Board Initiatives

Strengthened Principles Based Approach to Solvency

The Board has been considering alterations to the Standards to strengthen and reinforce the substance of the principles underpinning the concept of Solvency, as expressed in the Life Insurance Act. According to the Act, the purpose of the solvency standard is to ensure, as far as possible, that, at any time, the financial position of each statutory fund of a life company is such that the company will be able, out of the assets of the fund, to meet all policy and other liabilities referable to the fund at that time as they become due.

The Board considers that some matters that may be implied by the statement of purpose in the Act are not spelt out by the existing principles in AS 2.03, namely:

a) that the fundamental purpose of adopting ‘a basis more conservative than best estimate’ and the associated ‘scenarios of adverse experience’ is to allow either one of the following to happen:
   i. the statutory fund to be closed to new business for administration by a judicial manager and its obligations to be met as they fall due and with a high (i.e. prudential) level of confidence (the run-off of obligations test)
   ii. the statutory fund to be capable of being handed over to another life company to be run as a self-sufficient, standalone fund closed to new business (the transfer of obligations test).

b) that the Solvency Requirement must not be less than that calculated using the basis prescribed in the standard, but may be more.

c) that in considering the scenarios of adverse experience the Actuary must take into account all material risks (and the interdependencies between them that might apply under adverse conditions), regardless of whether they are discussed in the standard or not.

Allowance for Credit Shocks within LIASB Standards

The Board has been considering the extent of the existing framework of asset-liability mismatch provisions within the Standards and the potential for inclusion of explicit credit shock allowances.

The Standards do include some indirect allowance for credit risk through the use of the resilience, inadmissible asset and reinsurance asset admissibility tests. However, some sources of risk are not adequately covered e.g.:

- a systemic credit spread shock,
- entity-specific (micro-economic or non-systemic) risks,
- longer term reinvestment risks, and
- large scale counterparty risks.

The Board therefore is considering how to incorporate in the solvency and capital adequacy requirements allowance for a credit spread shock, and the extent to which other specific risks may need to be allowed for.
**Tax Effecting Termination Values**

The Board has been considering the extent to which account may be taken for any tax benefits that arise in the event of policy surrender when applying the minimum of MTV or CTV to the solvency or capital adequacy liability (and similarly when adjusting that liability for the calculation of resilience reserves).

The Board intends to alter AS 2.03 and AS 3.03 to include explicit statements to the effect that no allowance for tax relief should be made in applying any MTV/CTV minimum.

**Policyholders’ Retained Profits (PRP)**

The Board has been considering the extent to which the assets supporting PRP may be used to support the solvency and capital adequacy requirements in respect of non-participating business.

The Board intends to enhance those sections of AS 2.03 and AS 3.03 dealing with discretions so that they require that discretions allow for the likely distribution of PRP to policyholders under the scenario being considered.

**Admissibility of Subsidiaries**

The Board has noted recent instances where life insurers have treated subsidiaries (of both statutory funds and the general fund) as admissible for management capital and solvency purposes despite the fact that the operations of the subsidiary overlap with the operations of the life insurer.

The Board has been considering the extent to which such subsidiaries should be counted as admissible.

**Free Trade Agreement**

The Board has noted the possibility of a need to change the Standards as a result of the recent Free Trade Agreement with the USA. The changes would arise from the need to accommodate branch structures and would most likely affect only AS 6.02 Management Capital Standard.
Feedback

The Board welcomes feedback on any of the proposals raised in this issues paper. Responses should be submitted by **21 January 2004** to:

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